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Central Intelligence Agency

Washington, D.C. 20505

5 July 1985

MEMORANDUM FOR: Mr. Robert G. Adam
Office of Policy Planning
and International Affairs
Federal Maritime Commission

SUBJECT : West European Economic/Political Background Papers

Attached are the background papers that you requested on West Germany, France, the United Kingdom, Italy, and The Netherlands. As you suggested, we use the same format as in the set of country papers we sent you in 1982. If you have any further questions or if we can be of further assistance, please call me [redacted]

STAT

[redacted]

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Deputy Chief
Western Europe Division
Office of European Analysis

Attachments:
As Stated.

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WEST GERMANY

The Political Scene

Two issues have dominated the West German political landscape over the last month: the outcome of the North Rhine-Westphalia election and SDI. In the former, Chancellor Kohl's Christian Democrats suffered a decisive defeat -- their worst showing ever in that state. Blame for the defeat has been placed largely with the government in Bonn, and polls show Kohl's popularity lower than for any previous West German Chancellor. Free Democratic and Christian Social Union leaders are arguing for the government to address unemployment and assuage the fears of pensioners that budget balancing is coming largely at their expense -- the two primary reasons for CDU losses -- and Christian Democratic leaders generally rally behind Finance Minister Stoltenberg's firm stand on budget austerity. A series of meetings is planned for the summer and fall to discuss social and economic policy -- clearly with an eye to next year's state elections in Bavaria and Lower Saxony, as well as the federal contest in 1987.

Coalition differences also exist over West German participation in the Strategic Defense Initiative. Foreign Minister Hans Dietrich Genscher and his Free Democratic Party have maintained a more skeptical view of the project's feasibility and the possible technological pay-off for West German industry. They are also concerned that SDI might prove to be another blow to arms control and detente. As a result, they lean towards the Fench research proposal -- known as EUREKA -- which many in West Germany believe will correspond more closely to the country's need to advance its industrial technology. Many of the proponents of EUREKA suspect that the United States will control access to the technology developed too strictly, and some doubt that any civilian technologies will spin off from SDI. Even avowed supporters of SDI such as Chancellor Kohl and numerous Christian Democrats also find EUREKA attractive because it promotes the kind of West European economic and political cooperation that has long been a goal of Bonn's policy. But at the same time, they are unwilling to renounce possible support for private West German participation -- or even direct government involvement -- in SDI, particularly when EUREKA remains in the conceptual stage. Kohl and the Christian Democrats are also unwilling to directly oppose a project of great importance to West Germany's key ally and the leader of NATO. The Bonn government consequently will work towards a coordinated European response to both projects, recognizing that they are not necessarily mutually exclusive.

Economic Outlook

West Germany enjoyed the best GNP growth performance -- 2.6 percent -- among the major West European economies in 1984, and similar growth is likely this year. Exports have been the driving force behind growth as West German manufacturers take advantage of the strong dollar to expand foreign market shares. The traditional export sectors -- steel, chemicals, autos, machinery, and engineering -- are all benefiting. Foreign demand will remain the main source of growth in 1985, although export volume will not match the 8-percent increase of last year. Private investment in plant and equipment is proceeding at a strong 8-percent annual rate in real terms, as firms push modernization and industrial restructuring. Other components of the economy, however, are not faring as well. Private consumption has remained weak due to slack labor market conditions and higher taxes, while Bonn's devotion to budget-balancing has restrained public spending for both consumption and investment.

Consumer price increases this year will fall within the 2- to 3-percent range, continuing evidence of Bonn's success in taming inflation. Unemployment remains the most intractable problem; the 10.4-percent unemployment rate recorded in first quarter 1985 was inflated by unusually harsh weather, but the rate probably will remain stuck above 9 percent -- an alarming statistic by historical standards. The expected moderate rate of economic growth will not generate many new jobs, while high labor costs will continue causing German firms to adopt more capital-intensive production techniques. At present the Kohl government has no comprehensive plan to deal with the unemployment problem.

Foreign Trade

Exports of goods and services account for one-third of West German GNP, the highest share in the Big Seven. In the most important industrial sectors -- machine building, automotive manufacturing, chemicals, and electrical engineering -- export-to-output ratios range up to 55 percent. West Germany's annual trade surplus broke all records last year, hitting $18.7 billion. Exports rose 13 percent in value, led by a 43-percent surge in exports to the United States. The strong dollar has been a boon for West German exporters and a stimulus for the economy as a whole.

Manufactured goods, especially machinery and vehicles, account for 85 percent of West German exports; foodstuffs, raw materials, and fuels make up the remaining 15 percent. On the import side, manufactured products account for 55 percent of the total. Fuels -- primarily petroleum and petroleum products -- represent 21 percent.

West Germany: Foreign Trade, 1984
Billion US $

	Total	United States
Exports	171.7	16.4
Imports	153.0	11.0
Balance	18.7	5.4

Relations with the United States

Economic relations between the two countries are good, although Bonn is again concerned about protectionist sentiment in the United States. The West Germans are annoyed by toughened US restrictions on steel imports -- particularly for pipes and tubes -- but are resigned to the need for continued limititations on EC steel shipments to the US. Bonn backs the US call for a new GATT round, but probably will resist efforts to liberalize agricultural trade. West German farmers, a significant voting block for the conservative parties, need the protection afforded by the EC's Common Agricultural Policy.

FRANCE

The Political Scene

Next spring France will have its first legislative elections since the Socialists came to power four years ago, and economic issues are likely to be paramount. President Mitterrand and the Socialists will be presenting themselves as pragmatic and successful economic managers who have made the tough decision to pursue short-term austerity in an effort to promote long-term growth and modernization. The 1986 budget, to be proposed this fall, is likely to continue the austerity program. On the other hand, the conservative opposition will contend that austerity was necessary only because of initial Socialist excesses, and that the policy has not been as effective as the Socialists promised. The opposition's program is calling for a major effort to stimulate the economy by reducing taxes, spending, and government controls.

Public opinion polls indicate that the conservatives will win the 1986 elections handily, but Mitterrand's term runs until 1988. Under the present constitution, introduced in 1958, the president has extensive powers, but he has always had a legislative majority to support him. If the opposition does gain control of parliament, it is not clear where the ultimate authority would lie, and the French government could well bog down in internal debates until the situation is sorted out. Important legislation on economic and defense policy could get tied up in the confusion.

Economic Outlook

French economic growth this year probably will pick up only slightly from the 1.6-percent rate recorded in 1984 -- insufficient to reduce the unemployment rate which is now above 10 percent. The slight drop in unemployment over the last three months is probably only temporary; in fact, the French Economics and Statistical Institute (INSEE) projects unemployment as high as 11.5 percent by yearend. French officials do not believe they can stimulate the economy without reigniting inflation and creating balance of payment difficulties, particularly given the counterproductive results of their first attempt at stimulation in 1981. Instead, they are likely to stick to the austerity program they have been pursuing for nearly three years -- at least through the National Assembly elections next spring.

Although austerity has meant slow growth for France, it has lowered inflation and brought the current account into balance.

The inflation rate has fallen from over 13 percent in 1981 to 7.7 percent last year, and it could fall to about 6.5 percent in 1985 -- even though the annual rate for the first three months of this year has been above 8 percent. France has also managed to reduce its current account deficit from over $12 billion in 1981 to near-balance last year. Further rapid improvement is not likely this year, but recent downward movement in the dollar could produce a significant short term benefit.

During the past two years, the Socialists have faced up to some of the long-term structural problems of the economy. They have authorized employment reductions in steel, automobiles, shipbuilding, and mining, as well as in many other industries. They have also emphasized that the first priority of nationalized firms is to make profits, or at least to avoid losses, rather than to provide employment. By reducing taxes and other social charges, the government has helped firms restore profit margins that were badly eroded when the Socialists first came to power. The outlook for fixed non-residential investment has improved significantly in the past two years thanks not only to improved profits and falling interest rates, but also to an improvement in business confidence -- resulting from the perception that the Socialist government can behave sensibly after all and the belief that the right will sweep back into power next year.

Foreign Trade

Real exports of goods and services, which increased by nearly 10 percent between 1982 and 1984, have been the main source of growth in the French economy. Over the same period real imports of goods and services rose by only 2.2 percent. In 1984 the trade deficit reached its lowest level since the second oil shock in 1979.

In France, as in most other industrial countries, the energy sector is the main source of weakness in the trade balance, although France has an ambitious nuclear program that has reduced its energy dependence dramatically since 1973. The French traditionally have trade surpluses in industrial goods and agriculture, but the deficit on maritime shipping has been near $400 million for the last two years. Perhaps the most worrisome structural aspect of French trade is that bilateral surpluses occur mainly in trade with less developed countries -- the only developed country with which France has a consistent trade surplus is Switzerland.

French: Foreign Trade, 1984
Billion US $

	Total	United States
Exports	97.6	7.5
Imports	103.7	8.0
Balance	-6.2	-0.5

Relations with the United States

France traditionally has had a trade deficit with the United States. Slow growth in France coupled with rapid US growth and the appreciating dollar reduced the deficit to less than $0.5 billion last year on an FOB-CIF basis; on an FOB-FOB basis the trade balance probably was in surplus. French exports to the US have grown much more rapidly over the past two years on both a real and nominal basis than exports to the rest of the world, while imports from the US have grown less rapidly. Real exports to the US grew by 56 percent from 1982 to 1984 and have doubled since 1980.

Agricultural trade and policy probably is the most contentious issue between France the United States, with trade in cereals, corn gluten feed, soybeans, citrus fruits, and wine being particular areas of concern. France suspects that Washington is out to destroy the EC's Common Agricultural Policy and fears a trade war may be brewing. The French particularly resent recent US subsidies on agricultural exports to Algeria and Egypt -- markets France views as its domain. They are also concerned about what they see as growing protectionism, especially in steel and textiles.

UNITED KINGDOM

Political Scene

Despite sharpened criticism of her economic policies, Prime Minister Thatcher appears to be as self-assured as ever and remains committed to reforming the British economy and changing long-held social attitudes. She is convinced that she has forced voters to recognize and accept the limitations of government's role in the economy. Furthermore, she can point to her success during the miners' strike as evidence that rank-and-file workers are no longer willing to follow leftwing leaders blindly and that British trade unions are not the dominant force they once were. During the next 12 months or so, she will concentrate on pushing through as many of her controversial policies as possible -- including reform of the social welfare system, further denationalization of industry, and implementation of the Trident modernization program -- in order to assure that any successor government would have a difficult time changing the course she has set. By the middle of 1986, however, pressure to go slow on controversial policies is likely to increase, as the Tories become preoccupied with the next general election, due by June 1988.

The Labor Party and the Social Democratic-Liberal Alliance have made notable gains in recent municipal and county elections, but do not as yet represent a serious threat to Thatcher. The primary factors in Labor's improved standing are public anxiety over growing unemployment, the absence of hoped-for tax cuts in the March budget, and continued high interest rates on mortgages. Labor leader Neil Kinnock is using these issues to divert attention from his party's extreme leftwing platform on defense issues, which include support for unilateral nuclear disarmament and outright rejection of SDI participation. Alliance leaders -- who still have not articulated a clear policy platform -- are counting on divisions in the Labor Party and on increasing dissatisfaction among Tories to make the Alliance the "best" alternative by the time of the next general election.

Economic Outlook

The British economy is enjoying its fourth consecutive year of economic recovery, with most forecasters calling for real GNP growth of 3.5 to 4.0 percent in 1985, compared with only 1.6 percent last year. The economy is bouncing back from the nearly year-long coalminers' strike -- which reduced growth by an estimated 1.2 percentage points in 1984 -- and is benefiting from a healthy export performance as well as increased domestic demand. Consumer spending, influenced by higher real personal income, is expected to increase faster than last year, at about 2.5 percent, while growth in fixed investment most likely will slow from 7.6 percent in 1984 to between 2 and 4 percent, depending on trends in interest rates. Despite London's plans to reduce the budget deficit from more than $10 billion in the fiscal year ending this March to $7.7 billion in the current fiscal year, government spending will probably increase in 1985 due to a variety of factors, including higher than projected inflation and political pressures to combat rising unemployment.

The Thatcher government has had generally good success in controlling inflation since 1981 -- consumer price inflation was down to 4.8 percent at the end of 1984, compared with 11.9 percent in 1981. This year, the strong depreciation of the pound and a rise in mortgage rates caused inflation to bulge to 6.9 percent as of the end of April. The rate will probably peak at between 7 and 7.5 percent during the summer months and then gradually fall, provided that the government lowers interest rates somewhat and that the pound does not weaken.

In recent months, Thatcher has come under increasing criticisim -- even from a group of Tory backbenchers -- for not dealing effectively with high unemployment, which stood at 13.1 percent at the end of May and probably will continue to rise. The economic recovery has not created enough new jobs to compensate for the increasing size of the labor force. Moreover, long-term joblessness has increased even faster than overall unemployment because young people lack appropriate training and older workers possess skills no longer in demand. Critics of the government's laissez-faire approach believe that London should help alleviate the problem by undertaking more job creation schemes and increasing public investment.

Foreign Trade

Exports rose more than 2 percent last year in dollar terms (16 percent in pounds), due to strong world demand and the increased competitiveness of British goods as the pound depreciated. Strong growth in non-oil imports, in combination with rising coal and oil imports -- a result of the miners' strike -- pushed the trade deficit to $5.7 billion in 1984, following a $1.8 billion shortfall a year earlier. Reflecting this, the current account was near balance last year, compared with a $3.8 billion surplus in 1983. The trade account should improve somewhat this year because of the end of the miners' strike and because the pound is still relatively weak.

United Kingdom: Foreign Trade, 1984
Billion US $

	Total	United States
Exports	94.0	13.6
Imports	99.7	12.5
Balance	-5.7	1.1

Britain's major exports are manufactured goods -- primarily machinery and transport equipment, chemicals, and semi-finished goods -- and oil and oil products. Manufactured goods also occupy first place in the United Kingdom's imports, followed by petroleum and petroleum products, and food. Among the manufactured imports, machinery, semi-finished goods, transportation equipment, and consumer goods are all important.

Last year the United States was Britain's largest export market ($13.6 billion or 14.6 percent of total exports) and the second-largest source of imports ($12.6 billion or 12.6 percent of total imports), following West Germany. Manufactured goods account for 55 percent of exports to the United States followed by fuels at 28 percent; three-fifths of the manufactured goods consist of machinery. Seventy-five percent of imports from the United States are manufactured goods with machinery accounting for more than half of that total.

Relations with the United States

Prime Minister Thatcher takes great pride in her "special relationship" with President Reagan, which is based in large part on their similar ideological approaches to most economic, political and strategic issues. She counts on this friendship as a way of making British concerns known in Washington. At the same time, however, she must contend with charges from her opposition that she is too close to the President and blindly follows his will. Thatcher has supported the President on a number of important issues this year, including his SDI proposal, call for a new trade round, and criticism of Japan for failure to import more US and West European goods.

Nevertheless, there are areas of friction in the relationship. While the United Kingdom generally supports the goal of restricting high-technology exports to the Soviet Bloc, it would prefer a narrower, more enforceable list of controlled dual-use items than the United States. The United Kingdom also is generally opposed to Washington's use of trade sanctions as a means of achieving political ends. Finally, the British would prefer that Washington did not take unilateral action in international affairs without consultations with the NATO allies.

ITALY

The Political Scene

The Socialist-led government's victories over the Communists in the 12 May regional and administrative elections and in the 9 June referendum on the national wage indexation program have strengthened Prime Minister Craxi's hand following several months of tension. The Craxi government made it over another hurdle on 24 June when the Parliament selected Francesco Cossiga, a Christian Democrat, to succeed President Pertini.

Craxi now seems destined to remain in office at least through the end of the year and he may now be in a position to take advantage of the opportunity offered by the Communists' recent setbacks to press ahead with much-needed economic and institutional reform. In both areas, however, Craxi can expect difficult negotiations with his governing partners. On economic matters, for example, the coalition is split between those who favor tough enforcement of tax laws and a significant reduction of the burgeoning state deficit, and those who worry that pressure in these areas will hurt the coalition in the next election. On institutional reform, the small parties -- the Social Democrats, Republicans, and Liberals -- worry that proposals limiting recourse to the secret ballot would weaken their hand in Parliament; suggestions that parties should be required to win 5 percent of the vote to enter Parliament threaten to keep them out altogether.

Economic Outlook

Italy continues to enjoy the economic expansion which began in mid-1983. Strong export growth, and a jump in investment spending during the second half of the year, led to a real GDP increase of 2.6 percent in 1984. Rising corporate profits, increasing capacity utilization, and the need to modernize plant and equipment are likely to keep investment expenditures strong in 1985. Because of anticipated tax increases, however, consumption spending probably will be subdued. In addition, the slowing world economy will moderate export expansion, keeping real GDP gorwth to about 2.2 percent this year.

The government's principal economic objective has been to control the inflation rate. Cuts in Italy's automatic wage indexation system in the first half of 1984, and limits placed on administered price increases, helped bring the annual inflation rate down to 8.6 percent in the first quarter of 1985. Nevertheless, prices in Italy continue to rise at twice the rate of those in other developed countries, seriously eroding Italy's export competitiveness. Disputes over new wage contracts and a revision of value-added tax rates are likely to keep inflation running around 9 percent for the rest of the year, well above the government's 7-percent target.

Rome also faces the need to curb its budget deficit -- at 14.8 percent of GDP in 1984, one of the highest in the developed world. The government, however, lacks the political power to control spending or to broaden the tax base, and as a result the budget deficit in 1985 may surpass 17 percent of GDP.

Unemployment continues to rise in Italy despite the upturn in the economy. Growth has not translated into increased manufacturing jobs largely because industrial profits are being invested in new, labor-saving equipment. Although increased employment in the services sector has offset declines in industry and agriculture, it has been insufficient to cover the expansion in the labor force. Industrial employment probably will contiue to decline, pushing the unemployment rate to an average of 10.8 percent this year, up from 10.4 percent in 1984.

Foreign Trade

Italy recorded a $3.1-billion current account deficit in 1984 due to a doubling of the trade deficit. Although exports were strong throughout 1984, domestic growth spurred an even larger increase in imports. The government's inability to control inflation and the slowing world economy will result in a tapering-off of export growth this year. In 1984, 86 percent of Italy's exports were manufactured goods; clothing, footwear, steel, and office machinery are some of the exports that would be hurt by continued price increases. On the other side, more than half of Italy's imports consist of crude oil, petroleum products, and natural gas, and it is doubtful that Italy can reduce this energy dependence in the near term. These energy purchases and the strong import demand for investment goods are likely to cause the trade balance to worsen further this year.

Italy: Foreign Trade, 1984
Billion US $

	Total	United States
Exports	73.4	8.0
Imports	84.3	5.1
Balance	-10.9	2.9

Relations with the United States

The United States is Italy's third-largest trading partner behind West Germany and France. Reflecting the strong US economy and the appreciation of the dollar, exports to the United States nearly doubled in 1984 and accounted for 10.9 percent of total exports. Thirty percent of the US sales were consumer goods such as jewelry, footwear, and clothing. Semi-finished goods and machinery were also important trade items, in particular steel and automotive parts. Imports from the United States fell slightly in 1984 and accounted for 6 percent of total imports; aircraft, coal, computers, soybeans, and office equipment headed the list. US direct investment in Italy appears to have slowed in recent years, although portfolio investment remains strong.

Trade disputes with Italy appear to be on the rise. The Italian government has registered a strong protest over the raising by the United States of tariffs on pasta imports in retaliation for EC inaction on the GATT citrus panel ruling. Italy claims the action is unfair since it effectively focusses on only one member of the EC, even though the Italians have been the most persistent opponent of US proposals. The Craxi government also opposes the recent USITC recommendation to impose quotas on non-rubber footwear. Since Italian shoe exports to the United States have not increased in recent years, Craxi argues that the US should focus its restrictions on low-priced footwear and not limit Italy's more expensive shoe exports. Italy has implied that the US actions could hamper other bilateral negotiations. Rome is also concerned that the new US wheat export enhancement program will hurt Italian farmers. Although Italy does not sell wheat abroad, the government fears the US program will undercut French wheat exports to non-EC countries, and a surplus of EC wheat would mean extra costs to Italy for storing the excess grain.

THE NETHERLANDS

The Political Scene

The Netherlands is currently governed by a center-right coalition of Christian Democrats (CDA) and Liberals (VVD). The coalition has been pursuing an austere fiscal policy that has cost it significant support. Polls show that the coalition would lose its majority (now 79 seats) in the 150-member Second Chamber of Parliament if an election were held today. The CDA, the senior partner in the government, has benefited from the popularity of Prime Minister Ruud Lubbers, but the VVD is down significantly from its record-high showing in the last national election in 1982. The opposition Labor Party, traditionally Holland's largest party, is the principal beneficiary of the downturn in the government's fortunes.

Although the next general election is not due until May 1986, political maneuvering is already under way. The main focus is on the CDA, which is likely to remain a pivotal force in any post-election government. The CDA is attempting to maintain unity by publicizing its platform early and calling on the rank and file to unite behind it. On economic issues, the Christian Democrats are calling for more budget cutting, though with somewhat less emphasis on social welfare cuts, and are pledging greater job creation efforts. This policy is flexible enough to permit the party to continue working with the Liberals on their right, or to put together a coalition with Labor. Security issues -- particularly the question of allowing INF deployment on Dutch soil -- will be more difficult to resolve. The Christian Democrats are tenuously maintaining a united position supporting the government's June formula, which ties a positive decision on INF to Soviet deployments and maintains the link between INF deployment and reducing other Dutch nuclear tasks in NATO. The Labor Party, on the other hand, is a vociferous opponent of INF.

Economic Outlook

The upturn in the Dutch economy that began in 1983 is continuing: real GNP growth should be in the 2- to 3-percent range this year. The economy grew 2 percent in 1984, fueled by increases in investment, stock building, and the foreign trade surplus. Manufacturing output expanded 6 percent, led by the chemical and basic metals industries. Real private consumption, however, fell 1 percent due to austerity measures -- including wage restraints, reduced income transfers, and general public sector retrenchment -- implemented to reduce the spiraling budget deficit. Consumption is likely to pick up somewhat in 1985 when a combination of tax relief, very low inflation -- only 3 percent in 1984 -- and some moderate wage increases will permit real after-tax wage incomes to rise for the first time in several years.

An uncomfortably high level of unemployment remains the most critical economic problem facing The Netherlands. Unemployment jumped from 6 percent of the labor force in 1980 to over 14 percent at the end of 1984. Among contributing factors have been faster labor force growth since 1979, rigid wage structures, and an incompatibility between the skills of those entering the labor force and the available employment possibilities. Youth unemployment is especially serious (more than 30 percent of workers under 23 are jobless) and there is growing concern about its long-term effect on the nation's social fabric. Despite a variety of government-supported job training and subsidy programs, unemployment is expected to edge higher in 1985.

Foreign Trade

Foreign trade is of crucial importance for the Netherlands, as imports and exports each amount to over 50 percent of GNP. The trade surplus widened to $5.4 billion last year, up from $4.3 billion in 1983. Despite a small deterioration in invisible earnings, the current account surplus improved by $1.5 billion in 1984, to $4.9 billion.

Manufactured goods account for almost 85 percent of Dutch exports and are concentrated in metals, chemical products, food and tobacco, and oil products. Minerals (mainly natural gas) and raw agricultural goods make up the remaining 15 percent of Dutch export revenues. In contrast, raw materials and semi-finished products comprise more than 60 percent of Dutch imports, followed by consumer and investment goods.

Netherlands: Foreign Trade, 1984
Billion US $

	Total	United States
Exports	65.7	3.3
Imports	60.3	5.5
Balance	5.4	-2.2

Relations with the United States

In 1984, the United States accounted for 5 percent of total Dutch exports, taking $3.3 billion worth of goods. On the other side, the Netherlands is the third-largest market for US exports in Western Europe and the seventh-largest in the world. In the agricultural sector, the Netherlands represents the third-largest market (after Japan and the Soviet Union) for US commodities.

Direct investment both ways deepens the economic relationship. At the end of 1984, the over 1,000 US firms operating in Holland showed a book value of direct investment of $8.8 billion, making the United States the largest foreign investor in the country. The Netherlands has also long been a major source of direct investment in the United States -- with a total of more than $28 billion at the end of 1983.

On bilateral political issues, INF is of primary concern. A decision is due by November and will ultimately depend on the Lubbers government's perception of public support and of the chances for keeping the Christian Democrats united. While The Netherlands is a loyal member of NATO, a new generation of voters is more skeptical of the United States, particularly Washington's policies in Central America. The Dutch government has not yet taken a definitive position on participation in SDI research or on the initiative itself, which has been receiving a great deal of public attention and criticism in the Netherlands. The Lubbers government is leaning towards participation, but is mainly interested in reaping technological and economic benefits.